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# MAKING FLOATING PART OF A REFORMED MONETARY SYSTEM

REPORT

OF THE

SUBCOMMITTEE ON INTERNATIONAL ECONOMICS

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

JANUARY 9, 1974

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## LETTERS OF TRANSMITTAL

JANUARY 7, 1974.

*To the Members of the Joint Economic Committee:*

Transmitted herewith for the use of the members of the Joint Economic Committee and other members of Congress is a report of the Subcommittee on International Economics entitled "Making Floating Part of a Reformed Monetary System."

The views expressed in the Subcommittee report do not necessarily represent the views of other members of the Committee who have not participated in the hearings of the Subcommittee or in the drafting of this report.

Sincerely,

WRIGHT PATMAN,
*Chairman, Joint Economic Committee.*

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JANUARY 4, 1974.

Hon. WRIGHT PATMAN,
*Chairman, Joint Economic Committee,*
*Congress of the United States,*
*Washington, D.C.*

DEAR MR. CHAIRMAN: Transmitted herewith is a report of the Subcommittee on International Economics entitled "Making Floating Part of a Reformed Monetary System." It has been approved unanimously by the members of the Subcommittee.

The Subcommittee wishes to express its appreciation for the views it received from the Administration officials and the private expert who appeared before it as witnesses during the hearings preceding this report.

Sincerely,

HENRY S. REUSS,
*Chairman, Subcommittee on International Economics.*

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# MAKING FLOATING PART OF A REFORMED MONETARY SYSTEM

On November 13, 1973, the Subcommittee on International Economics of the Joint Economic Committee and the Subcommittee on International Finance of the House Committee on Banking and Currency conducted a joint hearing to review progress toward international monetary reform. This hearing was one of the former Subcommittee's periodic reconsiderations of how well the fluctuating exchange rate mechanism has been working. Members of both Subcommittees also wished to evaluate developments during the International Monetary Fund (IMF) and World Bank annual meetings that were held in Nairobi, Kenya, last September. Appearing as witnesses on November 13 were Paul A. Volcker, Under Secretary of the Treasury for Monetary Affairs, and Freeman H. Huntington, Senior Vice President of the First National City Bank in New York. Federal Reserve Chairman Arthur F. Burns testified before the Subcommittee on International Finance of the House Committee on Banking and Currency on December 5. The following report is based on the testimony presented in the joint hearing of November 13 and on Chairman Burns' subsequent appearance.

During the Fund's annual meetings in Nairobi, both the speeches delivered by some Governors representing Western European countries and the First Outline of Monetary Reform published by the Chairman of the Committee on Reform of the International Monetary System and Related Issues, commonly known as the Committee of Twenty, strongly suggested that the international monetary reform being contemplated would entail a return to fixed exchange rates. It said:

> The main features of the international monetary reform should include: an effective and symmetrical adjustment process, including better functioning of the exchange rate mechanism, with the exchange rate regime based on stable but adjustable par values and floating rates recognized as providing a useful technique in particular situations.

The Outline subsequently stated:

> Countries may adopt floating rates in particular situations, subject to Fund authorization, surveillance, and review.

The new Managing Director of the International Monetary Fund, H. Johannes Witteveen, said in his introductory speech:

> I welcome the resumption of the intervention by central banks since July. I hope this will prove to be a first step in a gradual move toward a situation in which intervention is

more widely used to stabilize exchange rates and to support an appropriate and internationally agreed set of currency values.

United States Secretary of the Treasury George Shultz observed in his speech during the meetings, "There is full acceptance of the idea that the center of gravity of the exchange rate system will be a regime of 'stable but adjustable par values.'" The "stable but adjustable" formula has never been officially defined. Three speakers at Nairobi, the Governors from Belgium, France, and The Netherlands, interpreted it as "fixed but adjustable." Much criticism was directed at the current fluctuating exchange rate mechanism, while defenses were offered infrequently and weakly.

This Subcommittee, in a report published on August 14, 1973, came to the following judgment:

> Comparison of the advantages and disadvantages of fluctuating exchange rates leads to the conclusion that, at this time when agreement among IMF members on how and when to adjust exchange rates to prevent balance-of-payments disequilibria has not yet been reached or implemented, fluctuating rates are presently the best available alternative, and are clearly superior to fixed parities.

The yearning for an early return to fixed rates evidenced at Nairobi prompted the hearings upon which this report is based.

World currency markets have had almost 10 months' experience under a floating rate regime. Monetary officials of the Group of Ten countries agreed in March 1973 to allow most major currencies to float in exchange markets. Each country maintained the option of "appropriate" official intervention to facilitate orderly conditions and, in the case of European countries,[1] to maintain the "snake" of fixed parities and relatively small margins vis-a-vis each other. Stable conditions ensued until early May, when growing American inflation and deepening domestic political uncertainties touched off a further decline in the dollar from the rate established in the February 1973 devaluation. By early July, speculative sales of dollars had driven the dollar price of German marks approximately 30 percent above the February level. As the month progressed, exchange trading in some European currencies was temporarily discontinued by a number of New York banks.

On July 10, following a conference of the Federal Open Market Committee and communication with European officials and the Bank for International Settlements, the Federal Reserve initiated cautious intervention in the New York exchange market. During the next 6 weeks, a strengthening in the U.S. trade position was announced and credit conditions eased abroad, particularly in Germany. Given these developments, the dollar recovered strongly. In recent months, intervention has continued, albeit more sparingly, and the dollar now stands close to its February 1973 level. Exchange speculation against the dollar has also declined and its range of daily prices has narrowed.

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[1] These countries were Belgium, Denmark, France, Germany, Luxembourg, and The Netherlands. They were later joined by Norway and Sweden.

In all, the Federal Reserve utilized a total of $512.4 million in swap drawings between July 10 and the end of October 1973 to finance its intervention operation. Intervention by the German Bundesbank to affect the dollar-mark rate amounted to nearly $500 million during the same period. Net dollar sales by the Bank of Japan from March through November 1973 amounted to almost $7 billion.

The present system can thus be characterized as a float modified by coordinated central bank intervention. This distinguishes the system from both a freely floating regime (i.e., with no central bank intervention) on the one hand, and a system of fixed but adjustable par values, such as under Bretton Woods, on the other. It can also be distinguished from other types of theoretically "flexible" or "fluctuating" exchange rate systems by its primary reliance on private markets rather than on actions by government officials to determine exchange rates.

The latter point is particularly important since the goal of more flexible exchange rates, which has generally been accepted by political and economic writers, is more easily reached in theory than in practice. The Bretton Woods arrangements, for example, envisaged flexibility of exchange rate adjustment, and yet its adjustable par values developed in practice into a system of fixed rates. Neither surplus nor deficit countries initiated timely or adequate exchange rate changes. The issue boiled down to the classic dilemma of the political autonomy of individual countries versus the authority of the international community, as the British Chancellor of the Exchequer, Anthony Barber, pointed out in Nairobi:

> At Bretton Woods our predecessors faced the same dilemma: the solution which they found was geared to the problems which they faced at that time and to the world as it then was. Experience and change have shown up the limitations of that solution. It simply does not work today. When nations have divergent trends, the Bretton Woods system does not identify with sufficient clarity which of the nations should make the adjustment. And in almost all circumstances, that system seems to weight the balance heavily in favour of the autonomy and discretion of the individual nation as against the joint interests of the international community.

We believe that the present system of floating exchange rates has passed the test of compensating for this major shortcoming of Bretton Woods. As this Report points out, we also believe that both the autonomy of United States domestic policies and the joint interests of the international community can best be served by making floating part of a reformed international monetary system.

### *Recommendation 1*

**For the foreseeable future, the dollar should continue to float in exchange markets.**

Stated most succinctly, the dollar should continue to float because the maintenance of this policy is in the best interests of the United

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States and will produce a higher degree of international economic stability and fewer upheavals than a return to fixed rates.

Throughout any analysis of the pros and cons of floating versus fixed rates, it is important not to be overwhelmed by the apparent lessons of the 1930's. Division of the world into three or four spheres of economic influence, each centered around a major currency or group of currencies, need not lead to mutual hostility and economic warfare. Even though "rules of the road" for central bank intervention in the exchange markets must be negotiated if we are to eliminate fears that exchange rates will be manipulated competitively, continued close communications and frequent face-to-face meetings among the world's monetary officials can reduce such fears substantially. At the present time, floating is the only exchange rate regime that permits each economic power the flexibility to realize domestic goals and at the same time not create major problems for other trading partners.

What are the explicit reasons for continuing with floating exchange rates? Six arguments are listed below.

**1. Given the potential for large international capital flows, the preservation of independent monetary policies requires floating exchange rates.**

In a world in which large amounts of capital can move quickly from one country to another, floating exchange rates are helpful for maintaining a reasonable degree of national autonomy in the execution of domestic economic policies, particularly monetary policies.

As the 20th century has unfolded, national governments have assumed the responsibility for maintaining consistently high rates of domestic employment, while at the same time attempting to keep inflation down to tolerable levels. In some countries the standards of performance expected from economic policymakers in terms of maximum tolerable rates of unemployment and inflation have become progressively more rigorous. Furthermore, a significant part of the burden of achieving either full employment or curbing inflation has been placed on monetary policy, a circumstance which has led at times to wide international differentials in interest rate structures. With fixed exchange rates, a difference of several percentage points between the domestic interest rates of two countries with comparably strong currencies encourages a movement of liquid assets from the nation with lower interest rates to the one with higher yields. By contrast, under a floating rate regime, the currency of a nation with higher yields tends to appreciate as foreigners buy its money and capital flows in. The appreciation helps to discourage further capital inflows.

A corollary of this argument is that under floating exchange rates, the pursuit of relatively independent monetary policies does not create the undesirable side effects which could be expected with a fixed exchange rate system. In any international monetary system, flows of liquid funds are affected not only by interest rate differentials but also by differences in economic conditions generally among countries. However, under floating rates, funds flowing from assets denominated in a weaker currency to those denominated in a stronger one tend to bring about the expected exchange rate adjustments, and thus diminish the incentive to transfer assets internationally. The beneficial effects of floating rates in helping to discourage an excessive international transfer of liquid assets was specifically mentioned by three speakers at Nairobi: Finance Minister Aichi from Japan, Bank of Italy Governor Carli, and German Finance Minister Schmidt.

By contrast, governments operating under a fixed exchange rate system can either attempt to block international capital flows by imposing exchange controls or permit the flows to occur but offset their exchange rate impact through central bank intervention. In either case the results are undesirable. Exchange controls tend to proliferate and thus to restrict international trade. Large scale central bank intervention—by expanding the money supply of the country attracting funds—plays havoc with the domestic monetary policy.

In his speech to the IMF Governors at Nairobi, German Finance Minister Schmidt said that "exchange rate elasticity will have to provide the needed protection" against large movements of capital that cannot be derived from international coordination of monetary policies and administrative controls. The cost of this benefit is some short-term fluctuation in exchange rates and the consequent effects on trade and investment. But no benefit is costless, and the economic damage resulting from massive central bank intervention in futile attempts to defend disequilibrium exchange rates has frequently been more costly.

Large volumes of liquid assets have accumulated in the Eurodollar market and national money markets that can be transferred quickly from one country to another in response to interest rate differentials or expected exchange rate movements. Possible transfers of these assets from one country to another will remain a potential problem for monetary authorities for decades to come. At the same time, a minimal degree of autonomy is desired by the authorities of each nation in the execution of domestic monetary policies. Only floating exchange rates, within internationally accepted guidelines, can provide the desired degree of autonomy and at the same time avoid massive, disruptive international capital flows.

### 2. Floating rates help contain inflation.

Floating rates help prevent the large international asset transfers and consequent reserve stock and money supply bulges that, for example, proved so troublesome for German domestic monetary management over the past decade. Otmar Emminger, Deputy Governor of the German central bank, argued in a lecture delivered last June that under the fixed exchange rate system, large U.S. payments deficits financed by the accumulation of dollar liabilities to foreign central banks became an international engine of inflation. By promptly compensating for payments disequilibria and by preventing excessive international transfers of liquid assets, a floating exchange rate mechanism helps avoid major increases in domestic money supplies and the ensuing inflationary consequences.

Also, by making prompt adjustments in exchange rates according to expectations of inflationary conditions in different countries, a floating rate regime can help contain within a country any inflationary pressures caused by excessive domestic demand.[2]

**3. The United States especially needs floating rates, even more than other countries.**

In contrast to other countries, the United States particularly needs floating exchange rates. The international trade of the United States is approximately 9 percent of gross national product, as opposed to some 40 percent in countries like Great Britain, France, and Germany, and even larger percentages in Belgium and The Netherlands. Unlike other countries, therefore, the United States cannot rely on overall monetary and fiscal policies to alter our international payments position. The expansion or contraction in GNP required to bring about a given change in our trade balance is simply too large to make the use of general monetary and fiscal policies reasonable.

The United States must therefore depend primarily on exchange rate adjustments to maintain an appropriate balance-of-payments position with the rest of the world. Although the proportion of international trade in the total output of the United States has been rising in recent years, it will not change dramatically. Certainly throughout the foreseeable future, it is in the best interests of the United States to let the dollar float in exchange markets according to internationally accepted guidelines.

**4. Exchange markets, since March 1973, have demonstrated their resilience and ability to maintain appropriate rates.**

The dollar has been floating in exchange markets since March 1973. During that period, the U.S. economy has suffered periods of considerable uncertainty. For example, in July, as a result of uncertainty about prospective levels of U.S. agricultural exports, inflation, a huge discrepancy between short-term interest rates in the United States and Germany, and reaction to political developments in the United States, exchange markets were on the verge of becoming disorderly. Buyers for dollars were virtually nonexistent, and requests to sell dollars were massive.

But a modest amount—compared with previous efforts to defend fixed exchange rates—of intervention by the Federal Reserve, an easing of monetary conditions in West Germany, and a strengthening U.S. trade balance quickly brought an end to the threatened disorder.

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[2] Suppose a nation, through an error in domestic monetary or fiscal policies or because of a capital spending boom spontaneously generated in the private sector, experiences a level of aggregate domestic demand greater than that country's capacity to produce, and therefore begins to suffer from inflation. Under fixed rates, the country will tend to export less and import more. This tendency to draw more resources from the rest of the world and to transmit demand pressures abroad meets no price resistance. By contrast, under floating rates, the value of the nation's currency would deteriorate in exchange markets. The consequence would be to make its exports cheaper in international markets and so help maintain the existing export level. In addition, imports would become more expensive domestically, and therefore the reaction to assuage domestic demand pressures by obtaining more goods from abroad would be curbed. Thus, on both sides of the trade account, floating rates help contain within a country any unsatisfied demand that has been generated there and prevent inflationary spending from spreading elsewhere.

Since early August, the dollar has generally been strengthening in exchange markets, and intervention has had the effect of holding the exchange value of the dollar down, rather than bolstering it.

Part of the explanation for this strengthening is the widespread belief among individuals involved in international commerce and investment that the United States will be less severely affected by petroleum shortages than Western Europe and Japan. But more fundamental reasons for the stronger position of the dollar in exchange markets are the shift in the U.S. balance of trade from deficit to surplus and the increase in foreign investment in the United States that have resulted from the realignment of exchange rates since 1969.

Throughout all of these trials, exchange markets have responded with an exceptional resilience and ability to establish rates that have permitted international investment and commerce not only to continue but to expand briskly.

Of course, after a dozen years of fixed exchange rates accompanied by massive central bank intervention from time to time, exchange dealers, international investors, and traders could not be expected to adjust instantly to the new conditions without first going through a period—which will continue for sometime—of learning, accommodation, and adjustment.

But the ease with which exchange markets have adjusted to the global economic shocks of the past 10 months should be compared with historical experiences under fixed rates and with what most likely would have occurred if monetary authorities had attempted to retain a fixed rate system. Under fixed rates, exchange market closings, the imposition of controls over capital movements, and massive central bank interventions were all common occurrences. With every significant change in economic expectations among the industrial countries, the system started to come apart. The same thing most likely would have occurred if an attempt had been made to maintain fixed rates over the past 10 months.

The record of monetary authorities in attempting to establish and maintain fixed exchange parities that were credible to the "market" has been undistinguished. There is no reason to believe that the performance of these authorities would be any better now than in the past if fixed rates were reintroduced. No international balance-of-payments adjustment mechanism is painless or costless. But comparison of events during the last three quarters of 1973 with developments from 1960 through last March indicates that adjustments are made more quickly, efficiently, and with lower costs under floating exchange rates than with fixed rates.

Continuing uncertainties in the foreseeable future, such as the economic effects of petroleum shortages, which could be intensified or loosened for particular countries at short notice, make adherence to a floating rate system—with guidelines—imperative. To cite Federal Reserve Chairman Burns' testimony before the Subcommittee on International Finance of the House Committee on Banking and Currency on December 5:

> In the past several months, a large number of economic, political, and military events occurred that had potentially disruptive implications for exchange markets. Despite these

disturbing events, orderly market conditions and general stability have prevailed. The official intervention that was undertaken has given us helpful experience in managing a system with exchange rate flexibility in a way that preserves orderly markets without frustrating desirable adjustments. Although I remain skeptical of the long-run viability of a floating exchange rate regime, this experience supports the continuance of the present exchange rate arrangements for the immediate future.

**5. Floating exchange rates do not necessarily impede expanded trade and investment.**

Critics of floating exchange rates frequently assert that such a regime tends to inhibit the growth of international trade and investment by creating economic uncertainty. It has already been argued that balance-of-payments adjustments occur more smoothly, efficiently, and at less cost under floating exchange rates than if rates are fixed. Moreover, no exchange rate regime can eliminate the uncertainties that result from major changes in fundamental economic conditions, which sometimes appear suddenly. International monetary arrangements, of whatever type, can merely attempt to bring about basic adjustments at least cost.

But how have international trade and investment fared under floating exchange rates? At the IMF's annual meetings in Nairobi, the Governor of Italy's central bank, Guido Carli, noted that notwithstanding the difficulties arising from exchange rate flexibility, "world trade has continued to expand at a record rate."

The latest IMF annual report notes that, due to reduced economic growth rates in several major industrial countries, including the United States, total world trade grew in 1971 at a rate of 5.7 percent as contrasted with the annual average for 1960 through 1970 of 8.3 percent. But in 1972 the growth rate of world trade returned to 8.2 percent, virtually the same as the long-term trend. In 1973, when the most serious adverse effects from closed exchange markets and floating rates might have been anticipated, the IMF annual report says:

> Imports into the industrial countries as a group continued to accelerate in the first several months of 1973, notwithstanding the fact that this was a period of marked deceleration * * * in the growth of imports into the largest importing country, the United States. In volume terms, world trade the first half of 1973 is estimated to have been about 12 percent higher than in the same period of 1972.

In other words, during the first half of 1973, world trade expanded at an annual rate that had not been equaled since 1968.

What about investments?

U.S. direct investment abroad expanded substantially during the first half of 1973. In fact, the total for the first half exceeded that for all of 1972. Probably U.S. direct investment overseas was reflecting increased domestic corporate earnings and brisk rates of economic expansion abroad, and had not yet fully taken into account the impact of exchange rate changes.

More interestingly, however, foreign direct investment in the United States during the first half of 1973 also exceeded the totals for all of 1972. During the second quarter of this year, foreign direct investment in the United States recorded the largest quarterly inflow since the first 3 months of 1970.

To be sure, many factors have helped promote both international trade and foreign direct investment in the United States during this period. With regard to trade, two dollar depreciations have made many U.S. goods competitive in world markets. Also, the phase III and IV regulations held prices of certain goods to levels which virtually forced some manufacturers to sell their products in the more profitable overseas markets. A major contributing factor to the rise in portfolio investment in the United States by foreigners—aside from the dollar devaluations—was the very attractive price-earnings ratios being posted by many U.S. common stocks.

The point is, however, that floating exchange rates did not discernibly retard the expansion of trade and investment.

**6. Floating exchange rates present no additional incentive for competitive rate changes.**

The Minister of Finance from The Netherlands, W. F. Duisenberg, raised in his address at Nairobi the possibility that floating rates might tempt governments to resort to competitive exchange rate depreciation during periods of high unemployment:

> Full employment is a high priority for national governments; if it were put in jeopardy, governments might conceivably resort to manipulating exchange rates for the benefit of their domestic policy, and the drawbacks of the present system of floating exchange rates would then appear fully and clearly.

This observation raises a legitimate point. No exchange rate regime or international payments adjustment mechanism can work without international surveillance. If a nation is experiencing high unemployment, it would reasonably be expected to ease its domestic monetary policy. The resulting decline in interest rates—even if temporary—could well prompt an outflow of capital and some deterioration in the value of its currency. With fluctuating exchange rates, an international body would be needed to insure that governments did not carry easy money policies beyond the point that could reasonably be expected to stimulate domestic expansion. Liberal credit availability should not be used to manipulate exchange rates and promote exports at the expense of other countries.

What this criticism overlooks, however, is that fixed rates are subject to the same fault. For years, the German mark and the Japanese yen were undervalued. The governments of these countries—under pressure from their export interests—refused to revalue these currencies, or to let them freely appreciate to a level that would have avoided further reserve accumulation. During these years of undervaluation, German and Japanese exporters were able to make rapid inroads into U.S. markets, resulting in some cases in substantial adjustment problems for U.S. industry.

Whatever the exchange rate regime, the IMF must be in a position to review the policies of governments that affect the external values of their currencies.

*Recommendation 2*

**In the drafting of an agreement to reform the international monetary system, the U.S. monetary authorities should insist that each IMF member retain the option of letting its currency float in exchange markets without the need to obtain any advance authorization from Fund authorities. The American demand that each IMF member have an unequivocal right to float—according to mutually agreed guidelines—should be clearly enunciated when the Committee of Twenty again convenes in Rome in January.**

The First Outline of Reform states that "Countries may adopt floating rates in particular situations, subject to Fund authorization, surveillance, and review." Surveillance and review will be necessary whatever exchange rate arrangements are adopted under a reformed international monetary system. But each member should have the unfettered right to opt for floating if it so desires and to allow market forces to determine from day to day the external value of its currency. Each member should be free to choose the type of exchange rate regime it considers appropriate for the characteristics of its national economy. The reform agreement should establish appropriate guidelines for the behavior of countries announcing a par value for their currencies and for others choosing to float. The International Monetary Fund should then be charged with implementing these guidelines and assuring that members adhere to them.

*Recommendation 3*

**Under a floating exchange rate regime, central banks should be permitted to intervene in exchange markets to maintain orderly conditions. Additional guidelines for central bank intervention under various circumstances should be developed by the Committee of Twenty and incorporated in any agreement to reform the international monetary system.**

In the hearings that have been held by this Subcommittee on the functioning of floating exchange rates, one permanent criterion for central bank intervention in exchange markets has been proposed that seems valid. Specifically, in the event that exchange markets are in danger of becoming disorderly (i.e., some currencies are being offered in large amounts but there are very few takers at any price, while other currencies are generally desired but unavailable), central banks should step in and perform a function similar to the "lender of last resort" responsibility they fulfill in domestic financial markets when a crisis threatens.

As exchange dealers and international traders and investors become progressively more accustomed to living under a floating exchange rate regime, they will perform more and more efficiently the function of smoothing fluctuations in rates that some central banks have occasionally chosen to take upon themselves. Moreover, if central banks are charged with the responsibility of smoothing fluctuations, they can easily and almost imperceptibly expand their activities into attempting to influence the trend of exchange rate developments. The history of repeated exchange crises in recent years demonstrates, however, that central bankers and treasury ministers are poor judges of what a country's exchange rate should be in even the immediate future. Moreover, circumstances can change dramatically within short time spans, sometimes from month to month.

Participants in exchange markets have a demonstrably superior record of appraising economic trends and are able to adjust more quickly and easily than officials to changes in circumstances. Commercial traders and investors have also shown that they are able to prosper under floating rates. But what they especially need, within each country, is a firm expectation of the regime under which they will be operating. Frequent changes from a par value to a floating rate system result in new acclimatization costs whenever a shift occurs. Each country, therefore, should decide which type of regime is best for it and reverse this decision only when the evidence for a change is overwhelming.

### *Recommendation 4*

**As the dollar strengthens in exchange markets, foreign central banks may desire to sell off some of their excess dollar reserves. U.S. monetary authorities should acquiesce in such sales so long as they do not constitute "dollar dumping" that results in the export of excessive amounts of commodities already scarce in the United States. Simultaneously with dollar sales by foreign monetary authorities to reduce the overhang, U.S. authorities should promptly begin to fulfill the pledge that capital export restrictions be abolished by the end of 1974 at the latest. As artificial impediments to capital exports are being eliminated, American citizens should—consistent with the maintenance of a strong dollar internationally—once again be permitted to own gold.**

In recent weeks, as the exchange value of the dollar has moved up in markets, foreign central banks have taken the opportunity to sell off some of their excess dollar reserves. The effect of these sales, which constitute a special type of exchange market intervention, has been to keep the dollar below levels that otherwise would have been attained. A sizable portion of the dollar overhang is the result of outflows of liquid assets from the United States during the past 2 or 3 years. If the dollar continues to make a strong showing in exchange markets, most if not all of these funds will return to this country. On the other hand, the remaining portion of the overhang consists of dollars that foreign central banks acquired either as the result of net sales of goods and services to Americans or from net investment overseas as Americans acquired direct interests in foreign firms or financial assets issued abroad.

Equity requires that as foreigners desire to make short-term investments in the United States or, more importantly, either exercise their claims on goods and services produced in this country or invest here, foreign central banks be able to sell off gradually their dollar holdings in excess of what these institutions desire to keep as working balances. Such sales, if conducted too rapidly, could finance the purchase at discount prices by private foreign individuals of large amounts of commodities, such as soybeans, lumber, or scrap metals, that are in short supply in the United States. If the supply shortages became critical, pressures for the imposition of export controls would arise. Since price or quantitative restrictions over international commercial flows are to be avoided whenever possible, the rate at which foreign governments reduce the dollar overhang should be periodically discussed between the United States and foreign officials. If the dollar overhang persists, eventual consolidation should be considered.

### *Recommendation 5*

**Under no circumstances should reduction of the dollar overhang explicitly or implicitly be allowed to become a vehicle for the reintroduction of fixed dollar exchange rates.**

Sales of excess dollars by foreign central banks should not appreciably distort the trend the dollar would otherwise follow in exchange markets and should under no circumstance be keyed to particular dollar exchange rates with other currencies.

In February 1973, Secretary of the Treasury George Shultz announced the Administration's goal of removing all restraints over exports of capital from the United States by the end of 1974. These restrictions consist of the Voluntary Credit Restraint Program administered by the Federal Reserve, the Foreign Direct Investment Program administered by the Commerce Department, and the Interest Equalization Tax. Since the United States balance of payments has reversed from a position of extraordinarily large deficits to a small and prospectively growing surplus, the rationale for maintaining these capital export restrictions has been considerably weakened. Given a policy decision to let the dollar float in exchange markets for the foreseeable future, which we heartily urge, the rationale for maintaining the restrictions will collapse entirely. U.S. monetary authorities should proceed promptly with the phasing out of these restrictions. In this regard, the announcement by the Administration on December 26, 1973, of a reduction in the Interest Equalization Tax and of several liberalizing changes in other aspects of the capital restraint program is a welcome step forward.

Throughout the 1960's, a number of measures, in addition to the capital export restrictions, were introduced to bolster the balance-of-payments position of the United States. For example, the Defense Department was directed to purchase supplies from abroad only if the price of the American-made product were more than 50 percent higher than the comparable foreign-produced item. This directive obviously increases unnecessarily the cost of national defense. Such Buy-Amer ican directives should also be abolished, and the full range of special balance-of-payments measures introduced in the 1960's and early 1970's should be reviewed to eliminate similar regulations that are now counterproductive.

Finally, as the U.S. balance of payments continues to strengthen, the President should exercise his authority under law to allow American citizens to own, buy, and sell gold as they desire. If U.S. monetary authorities are determined to relegate gold to the status of a commodity, then no other action would underline this resolve more convincingly than to make gold a commodity in the United States.

### *Recommendation 6*

**The International Monetary Fund should exercise continuous surveillance over the exchange rate practices, including market intervention, of its members. It should also from time to time issue public commentaries on the economic policies of its members and evaluate the international impact of these policies.**

The IMF is the appropriate organization for reviewing and evaluating the economic policies of its member states that have an external impact. In recent years, the Fund and its officials have been criticized for exercising what clearly ought to be the responsibility of this organization. Such criticism was unfortunate, and in the future, the Fund should be formally assigned this responsibility. Then allegations that the Fund has overstepped its authority will not be possible. While its critiques of the policies of member nations would have no binding authority, publication of its conclusions would help mobilize pressures from other member states toward a recalcitrant individual nation persisting in undesirable policies.

### *Recommendation 7*

**U.S. monetary authorities should inform the relevant legislative committees of the Congress before negotiating or agreeing to any but minor changes in international monetary arrangements.**

The appropriate legislative committees have not been kept sufficiently informed about the intentions of U.S. monetary authorities regarding their assent to sales of excessive dollar reserves by other countries, or regarding the impact of the decision to abandon the two-tier gold marketing agreement. Failure to keep the Congress informed raises the possibility that a series of small steps in a given direction might bring about a de facto monetary reform that the Congress might have objected to if the full facts had been available as plans were being formulated. Conscientious efforts should be undertaken to avoid any such misunderstanding.

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